

# Investment Committees: Vanguard's View of Best Practices

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**Executive Summary** Many individuals are called to serve on investment committees. For some, serving on a committee may be part of their job responsibilities; for others, it may be purely voluntary. But regardless of the nature of a committee's assignment—which can vary from overseeing the collective assets of individuals covered by defined benefit plans to managing the investment wealth of educational and charitable institutions—all members of investment committees share the unique fiduciary responsibility of making decisions on behalf of the current or future beneficiaries of a pool of assets.

In recent years, the environment in which committee members made these investment decisions was not an easy one; in fact, it is difficult to imagine a more challenging environment. The brutal bear market in equities from 2000 to 2002 and record low interest rates altered many committees' asset allocation decisions, return assumptions, and spending rules.

As an institutional money manager, Vanguard has had the opportunity to observe the activities of thousands of investment committees, ranging from those that oversee the largest asset pools in the United States to those entrusted with modest resources. In addition, a number of Vanguard's investment professionals and members of its senior management team serve on such committees. Based on their experiences as both committee participants and committee observers, we solicited this group's recommendations for a set of best practices that could be adopted by investment committees of any size.

The results of our survey indicate that the best investment committees share the following characteristics:

- An explicit understanding of a portfolio's purpose and objective and a clear definition of success in determining whether the portfolio fulfills that purpose and meets that objective.
- A charter outlining the roles and responsibilities of committee members, support staff, and—if applicable—consultants.
- A clear investment strategy that includes a reasonable set of assumptions about a sponsoring organization's risk tolerance and expected returns.
- A straightforward process for hiring managers to implement that investment strategy and for identifying the circumstances under which such relationships can be terminated.
- Common sense and discipline.

In addition, we identified the following qualitative traits, which can be hard to capture but are just as important as the characteristics listed on page 1:

- A recognition that investment theory is often at odds with behavioral tendencies, necessitating that committee members adopt a disciplined investment system and maintain their focus on the investment goals.
- A willingness by committee members to challenge and debate the issues at hand using facts and data instead of relying on strong opinions to prevail.
- A desire by committee members to establish constructive relationships and discussions both among themselves and with those with whom they work in order to be the best committee possible.

This paper discusses these best practices and provides advice about how an investment committee can incorporate them in its processes. The paper is meant to be a practical guide for current and prospective members of investment committees. For benchmarking purposes, we also compared best practices with actual practices for defined benefit plans and endowments, when data were available. The data we include are survey-based because most investment committee practices are not formally reported. The survey results are primarily for endowment funds. It is likely that information on investment practices is not widely available for defined benefit plans because many of these plans often have teams of individuals responsible for administering the plan, which includes handling recordkeeping as well as investment issues. Therefore, segregating the decision makers and the processes for plan investments can be difficult. We also recognize that the charters for investment committees overseeing employer-sponsored retirement plans are different from those of committees that oversee endowments or foundations. Retirement plan committees, for example, must incorporate regulatory and actuarial requirements into investment decisions. Rather than focus on the differences, however, this paper looks at what both types of committees have in common.

**Best practice #1:** *An investment committee should have an explicit understanding of a portfolio's purpose and objective and a clear definition of success in determining whether the portfolio fulfills that purpose and meets that objective.*

The purpose of an investment committee is to oversee a pool of assets. As such, it is imperative that the committee members share an understanding of the goal for that money and that they articulate the goal as explicitly and frequently as possible. A goal without a definition can be difficult to understand, and it can make it challenging for committee members to evaluate their progress toward reaching the goal.

A clear, realistic investment policy statement is the most effective way to define a portfolio's purpose and to measure a committee's progress in fulfilling that purpose. The policy statement also

serves as an objective framework for making decisions, some of which can be difficult. Since investment committees are made up of individuals who may have different attitudes and ideas about managing money, the policy statement can help to neutralize the emotional component that can intrude on a committee's decision-making process.

In addition to explicitly stating a portfolio's objective, an effective investment policy statement should always include:

- A summary of the committee's investment strategy, which should reflect the portfolio's objective. For example, "The assets are to be invested with the objective of preserving their long-term, real purchasing power while providing a relatively predictable and increasing stream of annual distributions in support of the sponsoring organization."

**Table 1**  
**Features of Investment Policy Statements: Endowments**

Assets	Asset Allocation Strategy Followed	Investment Objectives of Institution	Rebalancing to Maintain an Asset Allocation	Considerations in Hiring and Retaining Investment Managers
Greater Than \$1 Billion	92.1%	92.1%	64.5%	60.5%
\$501 Million-\$1 Billion	98.0	98.0	76.5	65.3
\$101 Million-\$500 Million	95.8	96.2	78.3	68.4
\$51 Million-\$100 Million	95.3	93.7	85.0	70.9
\$25 Million-\$50 Million	97.2	95.8	81.0	74.6
Less Than \$25 Million	96.1	96.1	78.7	71.0
Full Sample Average	96.0%	95.6%	79.3%	70.0%

Source: 2003 NACUBO Endowment Study.

- A process to evaluate the committee’s progress in meeting the portfolio’s objective, including a timetable for measuring that progress.
- A quantified measure of the amount of money to be spent in any given period.
- Guidelines governing the selection, evaluation, and, if necessary, termination of an investment manager. The guidelines should be specific enough to provide the committee with direction, but not so narrow that the committee can’t use its collective judgment.
- An explicit strategy for risk control, including an asset allocation strategy that governs the rebalancing of investments.
- Rely on the investment policy statement for guidance when making decisions about the portfolio.
- Act as fiduciaries, not as portfolio managers.
- Review the portfolio as a whole and recognize that some assets will outperform at various times while others will lag.
- Base decisions on facts and sound judgment, distinguishing between opinion and insight.
- Measure the success of the portfolio relative to its ability to meet the goals of the organization and not necessarily on how it fares compared with a benchmark or the portfolios of peer groups.

**Best practice #2:** *An investment committee should create a charter that outlines the roles and responsibilities of its members, support staff, and—if applicable—consultants.*

A successful investment committee starts with having the right people as members. In general, we suggest the following:

While a large number of endowments’ investment policy statements include definitions of the endowments’ asset allocation strategies and investment objectives, a much smaller number state their rebalancing and investment-manager policies. Table 1 lists responses to the 2003 NACUBO (National Association of College and University Business Officers) questionnaire, which surveyed more than 700 college and university endowments about what they address in their investment policy statements.

Of course, there are limits to how helpful an investment policy statement can be in a committee’s decision-making process. In the end, the committee’s collective judgment must prevail. In this respect, there are a few key qualities that successful investment committees share. In general, they:

- Do not confer membership as a reward.
- Avoid relying too heavily on a single committee member for either financial support or investment expertise.
- Avoid—or at least acknowledge—potential conflicts of interest. For example, it is inappropriate to hire the firm of a committee member as the investment manager.
- Identify the length of time that members are expected to serve and be clear about which positions are permanent (for example, the chief financial officer) and which rotate. Consider a

minimum of five years of service for those committees with the discretion to determine the length of members' terms.

- Do not rotate more than one-third of the members on or off the committee in any one term. This ensures continuity in managing the portfolio and avoids the risk of a wholesale shift in approach.
- Make sure that new committee members are familiar with the organization's investment goals and approach. Members should be seriously interested in investment issues but should not necessarily be investment professionals.
- Encourage members to regularly attend committee meetings and to document the committee's discussions and decisions so they take their participation seriously.
- Make sure that members understand their fiduciary responsibilities and, if applicable, the potential liabilities of serving on a committee. This is particularly true for members of committees that oversee ERISA (Employee Retirement Income Security Act)-qualified assets.
- Ensure that members are familiar with the guidelines for establishing and monitoring the portfolio by linking the charter to the investment policy statement.

No investment committee will be successful without an ongoing commitment to documentation, so there should be a clear process for recording a committee's activity and decisions. Keeping a written record of meetings assures continuity and accountability and is a useful reference when decisions need to be revisited. Oral history, while providing perspective, can be dangerous if relied on too heavily.

Investment committees frequently hire others—such as money managers and consultants—to handle a portion of their assignments. Committee members should communicate as much as possible about the organization they represent—its culture, challenges, and goals—to prospective staff members and managers during their evaluation. The best committees take advantage of the expertise these professionals can provide and avoid second-

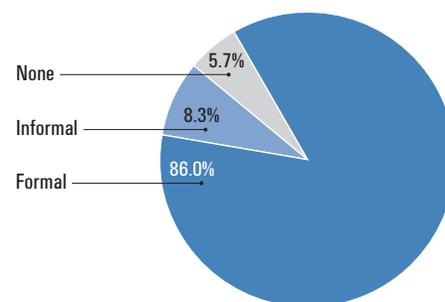
guessing their recommendations. Relationships with individuals or firms who are hired to assist the committee are strongest when there is open communication between all the parties involved.

**Best practice #3:** *An investment committee should adopt a clear investment strategy that includes a reasonable set of assumptions about the organization's risk tolerance and the portfolio's expected returns.*

Once a portfolio's objective is established, it becomes the committee's responsibility to decide how assets are invested and by whom. The investment strategy should *always* represent what is optimal for meeting the stated objective. If a pool of assets is targeted for a specific purpose and the organization has little tolerance for a potential shortfall, then the portfolio should be invested accordingly no matter what the market environment is at the time.

It is also important for the committee to have realistic expectations of investment returns. This is especially true for committees responsible for assets that an organization may need to meet expenditures. If expected returns and spending assumptions aren't considered together, there is a risk that assets may not be available when they are needed (for example, when a foundation needs to

**Figure 1**  
Investment Policy Features: How Endowment Earnings Relate to Spending Policy



Source: 2003 NACUBO Endowment Study.

fulfill its spending commitments). Forecasting returns is an inexact science. In general, committees should use conservative assumptions and consider the portfolio's performance history as a guide and not a predictor of its future returns. Market conditions over the lifetime of the assets will determine the portfolio's value, not average annual return assumptions. A mismatch between outlays and return expectations can result in increased spending at a time when assets are declining. In the *2003 NACUBO Endowment Study*, a majority of endowments reported that their investment policies addressed how their returns related to their spending policies, as shown in Figure 1.

Committees may also overlook risk control as an important consideration. Too often their focus is exclusively on a portfolio's future returns without evaluating its risks. Over the long term, an 80% equity/20% fixed income portfolio will have a higher expected return than a portfolio with a 60% equity/40% bonds allocation, but it may also have much worse performance over shorter time periods.

**Best practice #4:** *An investment committee should have straightforward processes for hiring managers to implement an investment strategy and for identifying the circumstances under which a relationship with a manager can be terminated.*

Once the portfolio objective is established, the committee must assign the responsibility for managing the assets. For most committees this means hiring one or more investment managers.

Using the investment policy statement as a reference, the committee should establish criteria for the selection of an investment manager, making sure that the criteria are multidimensional, instead of relying on a single factor. This is especially true when the committee evaluates a prospective manager's past investment returns. Performance should be considered as part of the evaluation process, but it should never drive the committee's decision.

In addition to following the guidelines established in the investment policy statement, the best committees:

- Clearly articulate to prospective managers the roles that the portfolios will be expected to play and the assignments for which they are being hired.
- Look beyond managers' "stories" and test their credibility by speaking with their clients—both current and former.

### Selecting a Manager

The process of hiring a manager to handle a portion of a portfolio can be complicated and time-consuming. As with other committee responsibilities, a disciplined approach to this process helps. In general, there are four key components in evaluating a potential manager:

- The nature of the manager's investment team and the firm for which the team works. Does the team have an individual or a collective approach to making recommendations? How long has the team worked together? If a single person manages the portfolio, does that individual have strong relationships with the firm's analytical group and trading professionals? How stable is the firm from a business standpoint? Answers to these questions can be important since individuals who are distracted by uncertain operating environments usually have less time to focus on investment issues.
- The philosophy that guides the investment firm and its investment process, which should be straightforward and meaningful.
- The firm's investment process, which should be a reflection of its philosophy and should be consistent over time.
- The manager's performance, which is the "proof of the pudding."

In our opinion, a manager's performance depends on the first three factors. If they are in place—or not, in some cases—it will be reflected in the performance.

## A Word About Spending

Almost all portfolios must address the need for withdrawing money. For a defined benefit plan, the amount of money needed to fund pension payments is a combination of the benefits outlined in the plan, actuarial assumptions, regulatory requirements, and accounting rules. In this circumstance, the investment committee, along with the professional staff charged with responsibility for the plan, must ensure that the plan assets can support both current and future liabilities. However, spending decisions for an endowment or foundation can be much more subjective. For this reason, having a clear—and unwavering—spending rule is imperative for a committee.

There are a number of ways for a committee to set a spending rule:

- It can identify a flat dollar amount and increase it annually based on the inflation rate.
- It can quantify spending as a percentage of assets (the most prevalent spending rules base this on average assets over a specified period of time). The 2003 NACUBO Endowment Study found that, on average, 82.4% of the 655 institutions given seven choices of spending-policy strategies chose a “prespecified percentage of moving market values” as their spending rule.

Before establishing a spending rule, the committee should address the following issues:

- For a committee using the “percentage of assets” rule, what is the sponsoring institution’s sensitivity to spending volatility? The committee may want to limit the impact of asset fluctuations on spending. In addition to using moving average asset values, governors can be employed to eliminate large fluctuations in the dollars spent from one year to the next. For example, the spending rule may be 5% of the rolling three-year average asset value, with a 5% governor up and down from year to year. Figure 2 illustrates this concept for two portfolios.
- What percentage of an institution’s operating budget or the budget of a sponsored program is the committee comfortable funding?
- Should the committee consider a spending cap? For example, the endowment will not provide more than 20% of the organization’s annual operating budget.
- What is the committee’s—or the sponsoring institution’s—tolerance for income fluctuations? What would happen if income dropped 10%? 50%? Some type of income modeling should be used to create different scenarios.

Figures 3a and 3b illustrate volatility due to asset fluctuations at two spending levels. A time-path analysis is used to illustrate the possible investment return paths that a \$50-million asset pool could take over time.

In the “real-path analysis,” we assume that the investment begins at a specific time in history (for example, 1960, 1970, or 1980). We then make certain assumptions about the annual spending level and determine the actual rate of return that the asset allocation would have earned each subsequent year. Once the date reaches 2003, the returns begin again in 1960 as an uninterrupted loop and continue to cycle until either the assets are depleted or the planning horizon has been attained. The best and worst years listed in Figures 3a and 3b represent the starting years for the paths that generated the best and worst returns.

**Figure 2**  
Rolling 3-Year Average Asset Value

Example 1	Upper Limit	Example 2
\$2,100,000		\$1,050,000
↑	5% of the Rolling 3-Year Average Asset Value	↑
\$2,000,000		\$1,000,000
↓		↓
\$1,900,000	Lower Limit	\$950,000

Source: Vanguard Investment Counseling & Research.

### Assumptions

- Asset balance: \$50 million
- Asset allocation: 60% stocks and 40% bonds
- Income taxes: 0%
- Planning horizon: 20 years
- Spending (\$ amount grown by inflation annually): 4%
- Return data:\* 1960–2003

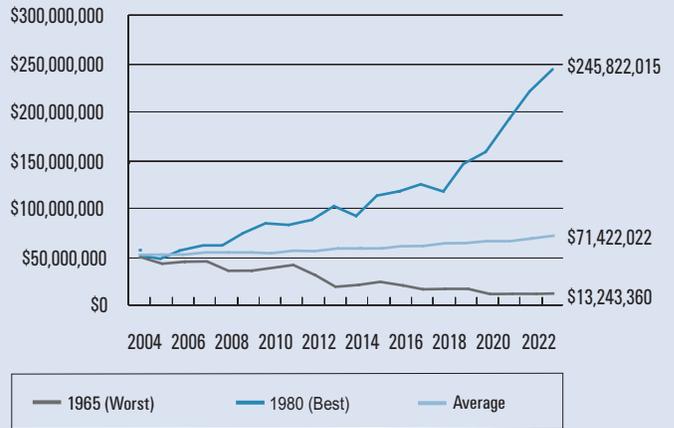
\* For stock market returns, we used the Dow Jones Wilshire 5000 Composite Index from 1971 to 2003 and the Standard & Poor's 500 Index from 1960 to 1970. For bond market returns, we used the Lehman Brothers U.S. Government/Credit Bond Index from 1973 to 2003, the Citigroup High Grade Index from 1969 to 1972, and the S&P High Grade Corporate Index from 1960 to 1968. For the returns on cash investments, we used the Citigroup 3-Month Treasury Bill Index.

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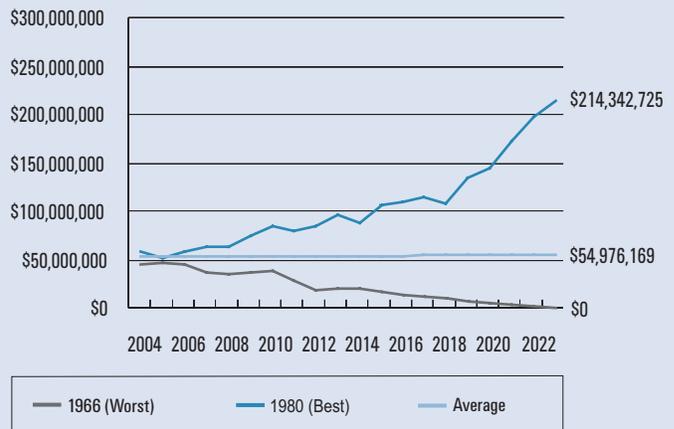
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**Figure 3a**  
4% Spending Level



Source: Vanguard Investment Counseling & Research.

**Figure 3b**  
5% Spending Level



Source: Vanguard Investment Counseling & Research.

- Do not approach the manager-selection process as they would if they were running a business. Many investment committee members are successful businesspeople who frequently—and rightfully—base their business decisions on short-term results. However, if committees were to use a short-term approach in evaluating the performance of potential managers and investment strategies, it could lead to poor decisions.
- Conduct both qualitative and quantitative man-

ager reviews. They look beyond the numbers and evaluate managers using truly independent information. This should always include reviews of the managers' overall business health. Finally, the best committees value the importance of a manager's solid record of compliance with regulators.

- Develop a strong level of expertise about investment issues.
- Allow adequate time to interview a potential manager, especially if the manager makes a

presentation to the committee. The best committees identify key questions ahead of time and aren't afraid to ask tough—but fair—questions.

- Pay close attention to managers' fees and consider using performance-based incentive fees. A committee should make sure that a manager's fee structure is aligned with the portfolio's time horizon. For example, the fee for an active equity manager—whose portfolio can vary quite a bit from a benchmark's over short time periods—should be based on performance over periods longer than, say, the trailing 12 months. Most important, the measure by which the manager is evaluated and paid should be closely aligned with the portfolio's objective.
- Understand that there is a point beyond which the investment manager is not likely to alter the core investment approach of his or her organization, so pursuing a “customized” approach might not be in either the portfolio's or the manager's best interests.

Many of the key points associated with successful manager selection hold true for manager oversight. Once a manager is hired, the committee should establish a managerial review process. How often is the manager expected to meet with the committee? What is the preferred style for written communication between the parties? In general, the best committees:

- Recognize that markets are cyclical and, as such, that there will be periods when a manager, or a group of managers, will do well and others when they will do poorly. An understanding of what drives those results helps committees to have constructive conversations with managers.
- Require that any outstanding issues be discussed, if necessary, in a written report. Such issues may arise during a manager's responses to questions during a committee meeting or in the normal course of business. The committee should keep track of any issues and how—or whether—they are resolved.
- Acknowledge potential pitfalls before they materialize. The performances of benchmarks and peer groups need to be scrutinized in addition to the performance of the manager's portfolio.

Performance numbers can be time-period dependent and should be evaluated over multiple periods. In addition, a committee should recognize that there may be a difference between conventional measurements of performance and those the committee is using to assess the portfolio's progress. The portfolio's relative performance versus a benchmark or peer group may not be the most relevant analysis.

- Match the right time period to the investment strategy. Applying a short time frame to analysis of a portfolio positioned for long-term results can result in poor committee decisions, which, in turn, can harm the portfolio's ability to meet the established objective. Three years should be the minimum time frame for evaluating the performance of an equity manager, and longer time frames should be used to evaluate the performances of more specialized strategies.

#### The Choice of a Full-Time Staff

Many endowments rely on a full-time professional staff to handle some of their responsibilities. These responsibilities can include administrative issues such as asset transfers, report preparation, and either direct investment management or manager oversight. The 2003 *NACUBO Endowment Study* found that the 291 institutions that replied to this question had an average of one staff member “whose primary responsibility is investment management.” For endowment institutions with more than \$1 billion in assets, that number jumped to five, as shown in Figure 4.

If a committee works with a staff, it's important to keep a few key things in mind. First, a committee's fiduciary burden is the same, with or without staff. Staff certainly can help the committee fulfill its fiduciary responsibilities, but staff cannot assume them. Second, there should be a document similar to the investment policy (which serves as a road map for the portfolio) that covers the roles and responsibilities of staff members. Once those assignments are clear, it's best if the committee allows staff members to do their jobs.

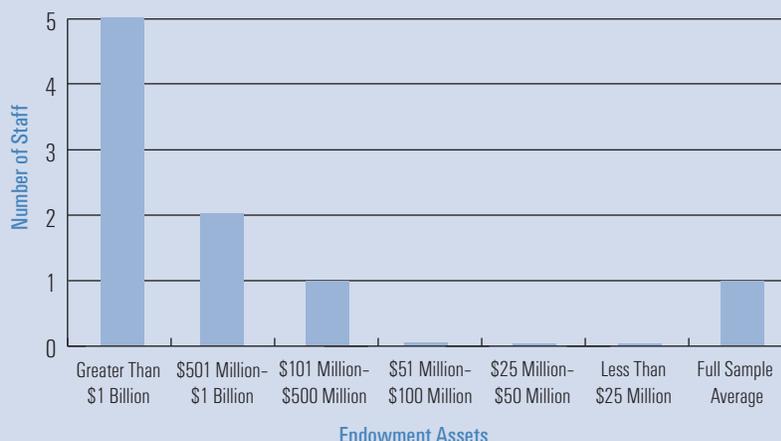
## Working With a Consultant

Many institutions and their investment committees hire consultants to assist with investment decisions. The *2003 NACUBO Endowment Study* and *PLANSPONSOR* magazine's 2002 study of defined benefit plans found that a majority of institutions employed outside consultants for investment management guidance, as illustrated in Figure 5.

Although the best practices discussed in this paper are still valid in these instances, committees that employ consultants should also consider other factors. Consultants, as with professionals in general, usually have various

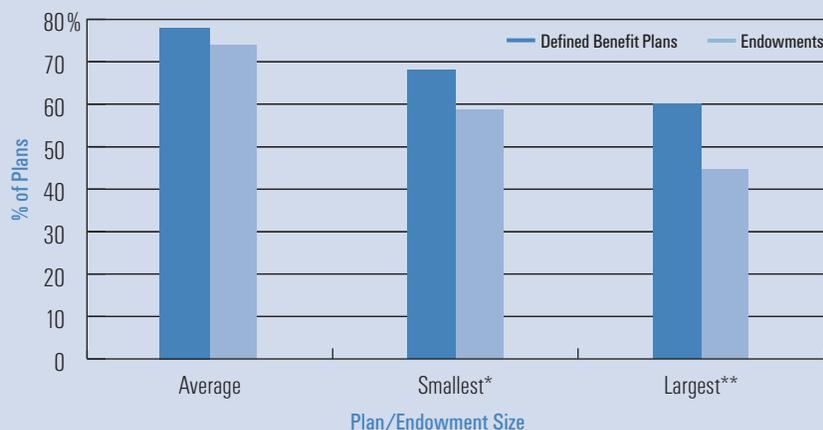
levels of expertise. When a committee chooses a consultant to help select and evaluate an investment manager, it should ask the consultant to disclose the consultant's process for doing this. Is it similar to the committee's? While many consultants operate independently, some may have business interests that could conflict with a committee's obligations. Committees should always require consultants to fully disclose and document all relationships, whether formal or informal, that any of their organizations may have with investment managers and service providers.

**Figure 4**  
Investment Management Staff: Endowments



Source: 2003 NACUBO Endowment Study.

**Figure 5**  
Use of Outside Investment Consultants



\* Defined benefit plans with assets under \$10 million, Endowments with assets under \$25 million.

\*\* Defined benefit plans with assets under \$10 billion, Endowments with assets over \$1 billion.

Sources: *PLANSPONSOR's, 2002 Defined Benefit Plan Survey*; *2003 NACUBO Endowment Study*.

**Best practice #5:** *An investment committee should exercise common sense and discipline.*

Serving on an investment committee is not easy. Members can have very different opinions about how to reach an objective, and they can espouse competing demands. Committee decisions may involve a trade-off between the immediacy of current circumstances and the commitment to future needs. The temptation for members to yield to short-term pressures is great. The best committees recognize these dynamics and manage to satisfy them by using good judgment. In general they:

- Do not invest in a particular strategy because

“everyone else is doing it.”

- Are skeptical when they hear “this time it’s different.”
- Remain committed to the objective and strategy outlined in the investment policy statement.

**Practices to Avoid**

While this paper focuses primarily on the practices committees should follow, there are obviously some they should avoid. Clearly, poor execution of any of the “best practices” and of items related to them would result in a less-than-optimal committee experience. There are, however, a number of overt actions that can

**The Behavioral Element**

An investment committee is a group of people who come together to make decisions about a pool of assets. As such, there are behavioral dynamics that should not be overlooked when either selecting members or working together as a group. Although there is a large body of research on group behavior, very little specifically deals with the dynamics of investment committees. Nevertheless, there are some useful conclusions from the more general research that can be applied to the investment committee experience.

- A group’s size, its members’ expertise, and its approach to conflict resolution, in addition to its members’ productivity, all have an impact on the group’s performance.
- Heterogeneity is critical to a group’s overall effectiveness.
- Members should be aware of the expertise that each of them brings to discussions.
- Committee members should feel personally responsible for the group’s decisions.
- While there is not enough research on group size to suggest the ideal size of an investment committee, some research suggests that a ten-member group benefits from being diverse without suffering the coordination problems

associated with larger groups. Actual practice somewhat mimics this finding. The 2003 NACUBO Endowment Study found that the endowment investment committees of reporting institutions had an average of ten members. (The actual number of members ranged from 3 to 50.) The NACUBO study also found that endowments with larger assets had larger committees, on average, as shown in Table 2.

**Table 2**  
**Investment Management Committees: Endowments**

Assets	Number of Individuals on Investment Committee	
	Average	Range
Greater Than \$1 Billion	11	4-27
\$501 Million-\$1 Billion	10	3-22
\$101 Million-\$500 Million	10	3-29
\$51 Million-\$100 Million	11	3-50
\$25 Million-\$50 Million	10	4-31
Less Than \$25 Million	8	3-31
<b>Full Sample Average</b>	<b>10</b>	<b>3-50</b>

Source: 2003 NACUBO Endowment Study.

undermine a committee and significantly reduce its probability of success, among them:

- Using an artificial measure of the portfolio's success that is not related to the portfolio's objective.
- Allowing one person's opinion to dominate, even if that person is an investment professional or a major donor.
- Acting as a portfolio manager and not as a fiduciary.
- Treating rebalancing as a market-timing exercise.
- Using performance as the sole criterion for the selection or termination of a manager.
- Making a decision because "everyone else is doing it."

### Summary

This paper reflects Vanguard's experience as a money manager working with investment committees, as well as the individual experiences of Vanguard's financial services professionals as committee members. Over the years, we have seen outstanding examples of investment committees at work. Unfortunately, we have also seen some committees struggle. Our purpose in this paper is to share some of our insights about what makes a committee work well—and not so well. In the end, every committee is charged as a fiduciary and attempts to discharge that responsibility in a way that offers the greatest probability of success for the management of an organization's assets on behalf of the beneficiaries of those assets.

### References

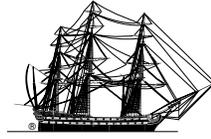
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### Questions to Ponder

No two investment committees are alike. The objectives and time horizons of portfolios vary, as does the interaction between the individuals charged with overseeing those portfolios. Clearly, what works for one committee might not be as successful for another. That said, committees might want to consider the following questions:

- Is there an explicit effort to reach outside of the committee's traditional constituency?
- Are committee members encouraged to be devil's advocates? Should that responsibility be permanently assigned to one or two members or rotated periodically?



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